

Grantor trust; charitable deduction. An irrevocable trust whose governing instrument provides for distribution of all ordinary income to organizations described in section 170(c) of the Code by the close of the year following the year of receipt, addition of capital gains to corpus, and termination of the trust and distribution of corpus to the grantor no sooner than ten years and one month after its creation is allowed a deduction under section 642(c)(1) for amounts of gross income paid to the charitable organizations, except to the extent the trust has unrelated business income.

ISSUE

Is a trust allowed a deduction for amounts of gross income paid out to charitable beneficiaries under the circumstances described below?

FACTS

Y, a bank holding company, created an irrevocable trust that will not terminate before ten years and one month after the date of its creation. The governing instrument of the trust provides that no additional property may be contributed to the trust after it is created.

The net income of the trust is to be distributed to organizations described in section 170(c)(1), (2), and (3) of the Internal Revenue Code of 1954. All income is to be distributed before the close of the year succeeding the year in which the income is received. Capital gains are to be added to corpus.

Y has reserved the power to designate recipients of income. Such designation is to be made at any time before or after the income is received. If Y fails to designate by the time income is required to be distributed, the trustee is required to select charitable beneficiaries. Distributions are to be made only from income received by the trust.

The trust agreement provides that all powers reserved by Y shall be exercised by Y in a fiduciary capacity and that none of the powers will be construed to permit the trustee to lend any of the principal or income of the trust property, directly or indirectly, to the grantor without adequate interest or security or to borrow directly or indirectly from the grantor at more than adequate interest or other consideration. Except in the case of permitted distributions, Y is prohibited from dealing with or disposing of the principal of the trust property or the income therefrom for less than an adequate consideration. Y is precluded from designating any distribution in satisfaction of its own obligation to a charitable organization.

Upon the termination of the trust, all of the property comprising the principal of the trust will be distributed to Y. All of the then undistributed income of the trust will be distributed to or for the use of the charitable organizations described above.

LAW AND ANALYSIS

Because the terms of the trust require the capital gains of the trust to be accumulated for future distribution to Y, Y will be treated as the owner of the income of the trust with respect to capital gains. See section 677(a) of the Code. Other items of gross income and deductions and credits attributable to the ordinary income portion of the trust will be subject to the provisions of subparts A through D (section 641 and following), part I, subchapter J, of the Code. See section 1.671-3 or the Income Tax Regulations. Thus, no deduction will be allowed to Y for any amounts of the trust's income paid to charitable organizations. The capital gains allocable to the corpus portion of the trust will be includible in Y's gross income when realized by the trust. See Rev. Rul. 66-161, 1966-1 C.B. 167.

Section 170(a) of the Code generally allows a deduction for charitable contributions paid during the taxable year. Section 170(f)(2)(B) provides, with respect to charitable transfers in trusts of income interests, that no deduction under subsection (a) is allowed unless the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest is a fixed percentage distributed annually, and the grantor is treated as the owner of such interest for purposes of applying section 671.

No income tax deduction was allowable to Y at the time of the creation of the trust since the income interest given to charity did not meet the requirements of section 170(f)(2)(B).

Section 642(c)(1) of the Code provides, in part, that in the case of a trust, there shall be allowed as a deduction in computing its taxable income any amount of gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c). If a charitable contribution is paid after the close of such taxable year and on or before the last day of the year following the close of such taxable year, then the trustee may elect to treat such contribution as paid during such taxable year.

HOLDING

Accordingly, except to the extent that the trust has unrelated business income within the meaning of section 681(a) of the Code, the trust will be allowed a deduction in accordance with section 642(c)(1) for amounts of gross income paid out to

charitable beneficiaries described in section 170(c) during its taxable year, or by the close of the following taxable year.